Banking during the Covid crisis: A CEO's perspective

Introduction

A global pandemic struck, and it soon became clear it was to become a major crisis for both public health and the economy. The U.K. economy and banking sector had witnessed crisis in recent history, albeit of a financial rather than public health nature; had this made them more prepared? How resilient were banks to another shock?

The financial crisis of 2008 was the impetus for the banking sector to consider better recovery plans, and financial regulation was stepped up in order to protect and help mitigate risk, protect consumers and make sure markets remained open and orderly. The Bank of England has recently cited that the banking system is in a stronger position than it was in the 2008 financial crisis due to the capitalisation of requirements that were introduced following this period.

This current crisis provides an opportunity to consider how effective banks and regulators were in achieving those aims, and if those aims result in a sector better equipped to deal with crisis, no matter its form.

Martin Stewart Chaired and mediated discussion on this subject with a number of CEO's and Chairpersons from Banks in the UK.

About Martin Stewart

Martin joined the Bank of England on the launch of the PRA in April 2013 and spent five years as a director. In addition to supervising UK banks, building societies, credit unions and new entrants into UK banking, he was a Member of the PRA's Executive Team responsible for PRA regulatory policy. His regulatory experience also includes spending three years at the FSA between 2010-2013, where he was a member of the leadership team that defined and implemented the UK's post financial crisis prudential regulatory regime that now underpins the work of the PRA. In addition to this, he has two decades' board-level experience having been Managing Director of a group of European subsidiary companies of the IFG Group PLC for almost four years, and as Chairman of the International Credit Union Regulators' Network for six years. Martin is now an advisor to banks, regulators and governments on regulatory matters and a non-executive director at Coventry Building Society and Danske Bank UK.

Executive Summary

This round table discussion, hosted by James Sayer of Sayer Haworth and Chaired by Martin Stewart, was an opportunity for CEOs of mid-tier banks to come together and discuss the impact of the Covid-19 pandemic on banking, including the role of U.K. government and the regulators.

The discussion was not necessarily to find answers, rather, it served as an opportunity to reflect on how the various actors of the U.K. economy have responded to the crisis, as well as contextual and crisis-specific challenges for mid-tier banks, and what this crisis will mean for those challenges going forward.

Of particular interest was the question - how do we mitigate risk and ensure operational resilience within banks?

Context - a pre-Covid world

1. Government

In some ways, the response of the U.K. government has been better than it was in 2008; in other ways there were challenges that made a cohesive, decisive response harder, such as:

- The single-focus of Brexit at the current time and in preceding years
- Lack of government infrastructure and investment due to austerity measures
- Lack of trust between various governmental agencies
- A relatively new government

2. The banking sector

The landscape of the banking sector was in many ways shaped by a post-recession world, more risk-averse and more heavily regulated than before the financial crisis. This has posed its own set of challenges to the sector, and this current crisis has pulled this landscape into sharper focus: did heavier regulation achieve what it set out to do?

The Financial Policy Committee (FPC), created as a result of the 2008 crisis, was designed to oversee the economy through a wide-angle lens, yet had perhaps become binocular in its vision on certain topics instead of considering issues more broadly. Climate change became an area of intense focus in recent time.

The FPC's focus was heavily on capital; just prior to this crisis the intention was to increase the capital conservation buffer by a further 1%.

The FCA's role was to ensure a regulated, open market with less intervention and to support consumers. The reality has probably been more greatly interventionist than planned, and heavily consumer-focused.

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Responses to the current crisis

1. Government

For the government, much of the financial stimulus has been more generous than might have been expected of a Conservative government, although some of their actions were deemed not swift nor decisive enough. The stance was clear: the economy must be maintained irrespective of cost, evidenced by furlough schemes and loans in the way of CBILS initially and then 100% government-backed bounce back loans.

The impact on and response of the banking sector has been mixed: to what degree are the loans responsible or desirable? How has the success of their implementation been? These are open questions, the answers to which will play out in a post-Covid world.

There was concern from the panel on the potential fraud in the system that will only come to bear when the loans have to be repaid. There is also the potential of high forbearance costs on the government; however, the panel felt that if this was the case, there would be a review on how the banks issued the lending and the checks they conducted. This would likely result in risk being returned to the banks' balance sheets.

2. Banks

Operationally, the response of the boards of banks at the start of the crisis generally fell into two camps:

- A proactive response, moving staff to work from home from the beginning of March in order to test remote working capacity, believing the virus could spread in the U.K. quickly, and that such a requirement could become immediately actionable.
- Those disbelieving the threat, who took less proactive action and instead decided to simply monitor the situation.

As we progressed through March, those banks within the first camp were on the front foot, with systems already in place that were up and running, and the latter camp were now on the back foot, struggling to manage the then-immediate need to change the way they worked.

It's important to note the latter camp was reflective of the UK government's position broadly during February and March, and is not an indictment on responses. It merely indicates a difference in response and how that impacted operations moving forwards.

Operational effectiveness was largely down to the speed in responses from banks rather than their business model. Even if banks had business continuity plans in place, many were not implementable due to the largely unforeseeable implications of the crisis.

That said, although the type and business model of the bank was generally not an indicator for a successful (or otherwise) COVID-19 response, those that rely on outsourcing were often more greatly impacted; inevitable perhaps given the lack of direct control over outsourced operations.

A particularly frustrating example for attendees present was the response of disaster recovery sites stating, *"You can't use these expensive sites you've paid for in the instance of emergency, because of the risk of spreading infection."*

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3. Bank of England

The Bank of England responded to the crisis with the tools available to them:

- Increased quantitative easing
- A reduction in interest rates to an historic low
- The re-introduction of the Term Funding Scheme, extended to accepting corporate debt as well

Could their response have included some more innovative thinking?

4. Regulators

Although the role of regulators can be a challenge for banks, which we explore in more detail below, for many attendees the response of the regulatory bodies has been flexible. This breeds questions of its own– was the pre COVID-19 ‘regulation heavy’ approach the right one, or has this crisis highlighted that a more pragmatic approach works better?

Challenges for banks

Challenges to the sector are brought into sharper focus in times of crisis, with contextual difficulties as well as Covid-19 specific challenges being discussed.

1. The role of regulators

It was generally agreed that while regulators have an important role to play, they don’t necessarily understand the differences between business models of banks, particularly those that are mid-sized.

Constant need to ‘tick box’ can contradict the demands of banking and the necessity to do things correctly. A lack of quality across the board and a lack of proportionality were discussed as key issues.

This has been highlighted during this time, as those who have responded pragmatically to the crisis and achieved optimal outcomes have not necessarily followed the regulatory frameworks of ‘good’ practice.

Perhaps at the heart of this is the expansion of regulators post-2008 and the logical contraction of which has never materialised. Not only has it remained static in size, it has remained static in policy. IFRS9, for example, was conceived in response to the Great Financial Crisis but the thinking behind it is coming up to a decade old. Policy needs to be fluid to keep up to date, adaptable to and reflective of current conditions.

2. Lack of cohesive thinking

Economists don’t always agree on the right course of action, so resultantly, there is not necessarily a single, unified response to moments of crisis for the economy. Banks, the Treasury and the Bank of England may each have a different perspective, and within those a variety of views; views that are subject to change, such as from a change in leadership.

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One such example – both prior to, and during the COVID-19 crisis – is the government's desire to stimulate competition within the sector and to reduce the reliance on the big five banks. This meant granting more bank licenses to a wider number of banks with various business models.

Regulators post-2008 however are naturally risk averse, process heavy and apply the same expectations and rules no matter the bank's business model.

As discussed, during the crisis the impetus of the government has been to lend. Banks remain wary of over-lending hence the move from CBILS to the 100% government-backed bounce back loans.

3. Negative interest rates

With the rates already being cut at a minimal 0.10%, the chance of negative interest rates is a very real possibility. Is this the right thing to do? Some economists believe it will help stimulate the economy whereas many others believe it won't, disbelieving that negative rates would filter down as banks would likely look to protect their balance sheets. There would likely be very little impetus for banks to do this.

The future: a post-Covid world

This crisis has highlighted a number of issues, which, as a positive, may help shape the way the banking sector (as well, perhaps, as the economy more broadly) could better mitigate risk.

Operational resilience is, and will continue to be, a key issue for the sector. The idea of an operations resilience agency was mooted.

Both banks and financial regulators need to ensure they are equipped to respond to crises in practicable ways, and not just rely on modelling and process. Real time simulations tend to work better than a list of due diligence on paper, which is something the sector may require more of going forward.

As demonstrated by the various responses of banks at the start of the crisis, and their success or failures relative to this throughout, *testing* of processes rather than simply having *lists* of process works best, as does the ability to act decisively. How, and to what degree banks outsource is an area to consider: where is the balance between cost-effectiveness and being fit for purpose during times of crisis?

The FCA and PRA may see fit to pare back elements of their role, understand how adaptability and flexibility are important, and understand the different models for a number of banks. This means blanket process and regulations aren't necessarily the key to achieving optimal outcomes.

Consideration needs to be given as to how to stimulate competition and lending – a desire of government – without increasing risk. This is something regulators as well as banks themselves wish to avoid. What is also important however is not burdening SMEs with unmanageable debt, something ubiquitous bounce back loans run the risk of doing.

Plans to recover quantitative easing remain unclear. To what degree this is achievable is uncertain, but more joined-up thinking between actors within the economy is clearly desirable.

Conclusion

As highlighted at the outset, the discussion was intended to share challenges, reflect on the current crisis, and understand the role of other agencies within the economy. While there were no concrete answers there were many questions, not just about this current crisis specifically, but how the banking sector moves forward in agile, yet resilient, shape.

Perhaps the banking and its regulatory sector can learn from this – are we risk averse in the right ways? Process is useful insofar as it mitigates actual crises; if they don't, they are at best pointless, or at worst negatively impactful for banks.

Many of the key discussions will bear light once we move out of the crisis. Many responses to the crisis will be shown as useful, indifferent or negative as we emerge from this time, for banks as well as for the economy overall.

The question for banking will be – how can we make sure we are best equipped for another crisis? Rather than individual lessons taken from a specific type of crisis, it is the agility of the sector in its response to any type of crisis that is crucial.

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